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TAGS: ECON MX PGOV PREL OVIP MORALES HECTOR
SUBJECT: SCENESETTER FOR THE VISIT OF USOAS AMBASSADOR AND SUMMIT COORDINATOR HECTOR MORALES TO MEXICO, SEPTEMBER 29-OCTOBER 1, 2008

¶1. (U) My staff and I warmly welcome you and your colleague to Mexico City and Monterrey. President Calderon recognizes the broad-ranging challenges his country faces and has the vision and political will to address them strategically. He has demonstrated resolve in implementing his key policy objectives: improving security and the rule of law, attacking poverty, and creating jobs. The U.S. and Mexico have developed a solid set of institutional relationships that allow us to work productively on most of our priorities, including fundamental issues of homeland security and North American prosperity. Those links are set to expand. Your visit is a sign of continuing U.S. support for the Calderon government and dedication to this complex, interdependent relationship.

Bilateral Relations and Hemispheric Integration

¶2. (U) Calderon has demonstrated pragmatism in his posture toward the United States and is building on an already modern and mature U.S.-Mexico relationship. The President's message is that Mexico will seek what it needs from us on the basis of equality, respect, and the close cooperation expected of neighbors that share wide-ranging interests and challenges. Our common border, responsible for extensive commercial, community, and family ties, is transforming our societies into two of the most deeply and broadly connected on earth.

¶3. (U) Calderon's top officials have been supportive of our new ideas for hemispheric integration, the Pathways to Prosperity, announced September 24th by President Bush in New York. President Calderon participated in that meeting, signed the communiquQ and the Mexican government has played a constructive role behind the scenes in helping shape the initiative. Nevertheless they are anxious to see how this new initiative might fare in a new Administration, as well as how it would fit in with others, such as SOA, the FTAA and such Latin American initiatives such as the Pacific Arc Forum. Calderon is eager to deepen commercial integration with the United States and the rest of the region, and is likely to support any forum that promotes economic development and broadening the benefits of free trade agreements.

Security

¶4. (U) There is increasing public concern over the rise in violence in Mexico. On August 30, more than 100,000 Mexicans marched peacefully throughout the country to demand government action against kidnappings and killings. The Calderon administration has moved forcefully to improve public security, significantly increasing the security budget; launching surge operations against drug traffickers

in ten of the most conflictive states; engaging the military in a significant way; working to overhaul Mexico's national police organization; getting the Congress to pass a major criminal justice reform; and authorizing the extradition to the United States of a record number of wanted criminals, including drug king-pins. The President's actions reflect his commitment to intensify security-related cooperation with the U.S., and his willingness to incur political risk in doing so. On June 30, President Bush signed the Merida Initiative, a 450 million USD package that provides funding for technical assistance and equi
pment for Mexico to use in their fight against narco-trafficking. This assistance is a key example of our cooperation in the counter narcotics arena.

Strong Leader in a Conflictive Environment

¶5. (U) President Felipe Calderon is showing strong leadership at home and abroad in a manner much appreciated by Mexicans. Although he won election with a bare 36% plurality in a three-way race, an opinion poll published Sept. 1 in the major daily Reforma showed that 62% of Mexicans approve of his performance to date. Nevertheless, the political climate overall remains conflictive, with a congress closely divided between the president's right-of-center National Action Party (PAN), the leftist Democratic Revolutionary Party (PRD) and the left-of-center Institutional Revolutionary Party (PRI). Calderon faces significant domestic challenges in pursuing his security, economic and social reform agendas. At the same time, he must chip away at the historic Mexican ambivalence toward the U.S. that has slowed progress on many

common fronts, including security. Because of this divided political environment, it is difficult to predict the results of the mid-term Congressional elections to be held in July
¶2009. PRD' s fortunes seem to be waning and good showings by PRI candidates in state and local elections over the past year may be a harbinger of strong gains in next year's mid-term elections.

Stable but Vulnerable Economy

¶6. (U) U.S. strategic interests in Mexico are tied to three key economic factors: (1) a population of 110 million bordering the United States with a poverty rate over 40 percent, (2) the second largest supplier of oil to the U.S. in 2007 (though so far this year it has slipped to third behind Canada and Saudi Arabia), (3) over one billion dollars a day in two-way trade in goods and services, with a highly integrated production cycle between factories in the U.S., Mexico and Canada.

Poverty and Economic Performance

¶7. (U) Mexico has the highest income inequality of any nation in the OECD. The latest Mexican government figures, (from 2006) show the poverty rate declined slightly to 42.6 percent overall, with 10.3 percent living in "food-based poverty," unable to meet the nutritional needs of their families. Widespread poverty encourages illegal immigration, narcotics smuggling to the United States, and other forms of illicit commerce. Growing income inequality fuels the tensions that almost resulted in the election of a populist President, Andres Manuel Lopez Obrador, who openly embraced President Chavez of Venezuela.

¶8. (U) President Calderon inherited a stable, growing economy tightly linked to U.S. economic cycles. Mexico chalked up an estimated 3.3 percent growth rate in 2007, rebounding from near zero growth in the first years of the decade. Real GDP growth is expected to slow to around 2.6 percent this year, primarily due to the U.S. economic slowdown. Inflation,

fueled by spiking international food and energy prices, has risen in recent months to over 5 percent, prompting the Central Bank to raise interest rates
in June 2008, shortly after the government had reduced import tariffs for key food items, increased subsidies for poor consumers, and obtained voluntary price controls from producers. Most jobs currently being created in Mexico are in the informal economy, which the World Bank estimates employs 27-45 percent of the working age population. Many here are growing concerned about Mexico's ability to compete in an increasingly globalized world, as it loses market share to China and other emerging economies. In his second State of the Union Address, issued on August 27, Calderon claimed that 800,000 formal jobs have been created in Mexico. Mexico has achieved a 3 percent GDP growth, not bad for a global environment characterized by recession and high inflation, but still insufficient to progress. Calderon highlighted that Mexico, except Canada, had the lowest inflation in America.

Need for Bolder Economic reform

¶9. (U) World Bank, OECD, Mexican and other economists say Mexico would need sustained, long-term growth rates of at least six percent to alleviate widespread poverty -- but cannot achieve that level of growth without structural economic reform beyond what President Calderon has currently proposed. We agree with Finance Minister Agustin Carstens that in order to compete internationally and develop the poorest parts of Mexico, Mexico needs broad reform to improve tax collection, reduce reliance on oil income, confront growing pension liabilities and payments on government borrowing outside the federal budget, and provide needed spending on poverty alleviation, education, health and infrastructure. Mexico desperately needs education reform, since currently 60 percent of its people do not graduate high school. In order to achieve sustained robust growth, Mexico must improve competition in an economy long dominated by business monopolies and oligopolies, and to take on powerful labor unions (including the natio
nal teachers union) in order to amend labor laws that discourage job creation in the formal economy.

¶10. (U) While President Calderon has achieved more reform in his first two years in office than his predecessor did in six

years, the lack of a majority in Congress has forced him to compromise with the special interests that have long slowed progress in Mexico's economy. While the President's skill at pragmatic political negotiation has led to a series of successful economic reforms, it has also meant the reforms were watered down and are not yet sufficient to place Mexico on a sustained growth path sufficient to alleviate widespread poverty. Reforms to date include a tax reform that solved about one-third of the need for additional collections, and a pension reform that combined with that of his predecessor solved about 80 percent of the insolvency crisis in Mexico's pension systems.

¶11. (U) To overcome a key barrier to economic growth, President Calderon has announced a National Infrastructure Plan, under which his government would spend five percent of GDP for the next five years to improve Mexico's long-neglected infrastructure. The President recently joined with the leader of the national teachers union to announce a program to improve primary education, although many are skeptical that the union will allow real reform. On August 6, Calderon named his pro-business former chief of staff, Gerardo Ruiz Mateos, to be the new Secretary of the Economy to aid him in the battles against rising inflation, falling remittances, and the informal sector. While Calderon's government has taken incremental steps to reduce the market dominance of monopolists and oligopolists in key sectors like telecommunications and banking, Congress has blocked serious reform. Currently, Mexico is in the midst of a heated debate

over the President's rather modest energy reform proposal (see below).

Actively Seeking to Expand Trade and Investment
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¶12. (U) President Calderon has made increased international trade and investment a cornerstone of his presidency. In June 2007, he created ProMexico, a federal entity charged with promoting Mexican exports around the world and attracting foreign direct investment to Mexico. He has also worked to strengthen economic relations with European and Asian countries in order to lessen Mexico's dependence on the U.S. economy. Last year, Mexico's FDI inflows reached a record 23 billion USD while at the same time the percentage of such inflows originating in the U.S. decreased to 47.3 percent, only the second time since NAFTA implementation that the U.S. has accounted for less than half of Mexico's FDI. Mexico has also seen its percentage of exports to the U.S. decrease from 87 percent in 2004 to 82 percent in 2007. As the U.S.'s economic slowdown continues, Mexico will expand efforts to diversify away from a U.S. centered economy.

¶13. (U) That said, Calderon is eager to deepen commercial integration with the United States and the rest of the region, something his government views as essential to strengthening competitiveness vis-a-vis competitors, especially from Asia. In March, Calderon stated that Mexico was ready to talk to Panama about restarting stalled discussions on a free trade deal. Discussions over a Mexico-Peru FTA have entered the final round. Mexico sees the August 15 entry into force of the CAFTA-DR textile accumulation provisions as a model for linking together the free trade agreements among common partners in the Hemisphere, and is working with like-minded Latin countries in the Pacific Arc Forum to harmonize rules of origin among common free trade partners.

Energy

¶14. (U) After Canada, Mexico was the largest source of U.S. oil imports last year. We therefore have a strong strategic interest in continued stable supplies of Mexican oil. Within Mexico, energy is an extremely sensitive topic tied to national sovereignty, but the energy sector requires difficult reforms urgently. Mexico's oil production and reserves continue to decline due to a lack of investment in oil exploration and production. Sufficient investment funds are not available because of the constitutional prohibition on private investment and the fact that most of Pemex's revenue goes to pay for as much as 38% of the government's budget. Pemex's liabilities have grown so large that it can no longer fund investment in exploration through borrowing in international markets. President Calderon understands that declining oil production can only be addressed through fiscal reform to reduce the amount of Pemex revenue sucked into the government budget, and through energy reform to improve the

efficiency of Pemex operations and allow for private and foreign investment in the petroleum sector.

¶15. (U) A comprehensive tax reform package was passed last year and there is currently a mild energy reform package being heatedly debated in the Mexican Congress as well as in the court of public opinion. Initial indications are that some type of energy reform is likely to pass and could provide some additional flexibility for PEMEX and pave the way for further reform. Analysts anticipate an intense month plus of congressional discussions which could lead to a consensus package being passed by early October. (The Mexican Constitution requires that the federal revenue and appropriations bills be approved at the end of October and mid-November respectively, and both of these will be heavily impacted by any reform to PEMEX.) While the package that the

Calderon administration submitted to Congress would not open Pemex up to the level of investment that it sorely needs, it seems to be a small but important step toward the large task of reforming Pemex. While polls indicate that most Mexicans now understand som
ething needs to be done with PEMEX, unions and opposition parties reflect the views of many Mexicans who are skeptical of foreign involvement. Even seemingly benign, factual statements by U.S. officials about Mexico's petroleum sector, such as those made by President Bush in March 2007 or former Fed Chairman Greenspan several months later set off a tempest of responses and front page condemnations, including from officials largely supportive of opening the sector.
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